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Agenda Item 4b(2)

August 15, 2011

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. **SUBJECT:** Update on the Neutrality Trial Responsible Contractor Program Policy and Program Extension Request
- II. **PROGRAM:** Real Estate
- III. **RECOMMENDATION:** Extend Neutrality Trial Program to June 30, 2013
- IV. **ANALYSIS:**

INTRODUCTION

In February 2010, the Investment Committee approved the Neutrality Trial Responsible Contractor Program (Neutrality Trial RCP) Policy and its corresponding Neutrality Trial Program (NTP). This agenda item provides an update on program participation, and recommends extension of the program for an additional year. A complete annual report on RCP and NTP compliance is scheduled for December of this year.

At the February 2010 meeting, the Investment Committee asked staff to consider the inclusion of construction contracts for the second year of the NTP. While staff recommends against inclusion of construction contracts at this time, staff does recommend the approval of an extension of the NTP from March 31, 2012 to June 30, 2013 in order to gain more experience under the trial program. Please see discussion of staff's recommendations below.

PCA, the Board's Real Estate Consultant, has reviewed this agenda item and will be available at the meeting to respond to questions of the Investment Committee. See consultant opinion letter (Attachment 1)

NEUTRALITY TRIAL PROGRAM UPDATE

At the Program's inception date, all eight Core investment managers volunteered to participate in the NTP and as a result, the 2005 RCP Policy no longer applied to those managers. Due to portfolio restructuring, three Core managers are no longer in the Program. After the implementation of the NTP, GI Partners became part of the Core Real Estate Program. GI Partners agreed to volunteer for the NTP. GI Partners has a track record of contracting under union labor agreements.

As a means of understanding delegate (contractor) and subdelegate (subcontractor) participation, staff requested that investment managers provide a list of any delegates and subdelegates that have:

- 1) Volunteered to be bound by the NTP
- 2) Not volunteered to be bound by the NTP
- 3) Any new contracts, subject to the NTP, that were entered into during the period
- 4) Any new contracts that were entered into during the period that did not volunteer to be bound by the NTP
- 5) Contracts that required an exemption from the neutrality requirement.

Additionally, staff requested that investment managers provide the relevant terms of those respective contracts (dollar amount, contract term, and brief scope of work). The results of the request are below:

- At the time the program was approved, there were 56 existing contracts totaling \$22.9 million that met the program criteria:
 - 44 delegates and subdelegates volunteered to be bound by the NTP. Those contracts totaled approximately \$19.8 million.
 - 5 delegates and subdelegates did not volunteer to be bound by the NTP. Those contracts totaled approximately \$2.1 million.
 - 7 delegates and subdelegates did not respond to the request to voluntarily be bound to the NTP. Those contracts totaled approximately \$1.0 million. The 7 non-responsive contracts are attributed to a manager that is no longer in CalPERS Real Estate portfolio. At the time staff made the request for information the manager was in the process of transferring their multi-billion portfolio to another manager.
- The program requires all new contracts to be subject to the NTP. During the first year, 21 new contracts were entered into totaling approximately \$9.3 million.
- One contract, totaling \$122,000, required an exception to the neutrality requirement.

The neutrality exception was regarding an asset at a secure airport site. The airport authority limited the number of companies approved to submit bids, due to security regulations. Neither of the two approved snow removal companies accepted the terms of the NTP. The exception was granted by LaSalle Investment Management on August 27, 2010 for the snow removal contract at the Aero Syracuse property in the CalEast Global Logistics portfolio.

REQUEST FOR ONE YEAR EXTENSION

The purpose of the NTP is to gather data on the investment impact, if any, of requiring manager, delegate, and subdelegate neutrality in the event a labor organization lawfully attempts to organize workers providing services at a RCP investment. The NTP provides standards for determining whether the NTP has been successful. The Policy requires staff, at the end of the two-year period, to report NTP results, with recommendations for expanding the neutrality requirement to a broader Real Estate Program if the NTP is deemed a success.

In 2010, the Core Program experienced relatively low investment activity in response to economic conditions and portfolio restructuring. The relatively small amount of contracting activity is insufficient from which to draw conclusions or to make recommendations for program expansion. In an effort to gather more meaningful experience and data under the program, staff recommends that the Investment Committee approve extending the term of the NTP from March 30, 2012 to June 30, 2013.

INCLUSION OF CONSTRUCTION CONTRACTS

Staff considered expanding the NTP to include construction contracts. Staff looked at current Core program construction activity and found only 60 construction contracts, totaling \$767 million, across the entire \$8 billion (NAV) Core real estate program. One manager, GI Partners, makes up 99% of all contract value. Approximately 98% of GI Partners contracts are under union labor agreements. For the current fiscal year, the majority of construction activity is expected to occur in the highly unionized GI Partners portfolio. The level of unionization in existing and upcoming construction contracts renders NTP participation not meaningful because neutrality is not at issue.

The balance of the 22 construction contracts totals approximately \$5.6 million. The limited construction contracting is evidence of the current challenging market conditions.

In an effort to further understand the potential impacts of expanding the NTP to include construction contracts, staff queried Core investment managers. In response, investment managers expressed serious concerns including uncertain highly competitive market conditions; implementation of portfolio repositioning and restructuring (including large legacy portfolios); and market demand for quick turn-around of tenant improvements. During the last policy revision process, the concept of including construction contracts was discussed at length. Construction contracts were ultimately not included in the NTP because of the investment managers' concerns. Those concerns remain unchanged.

In light of the high level of unionization in construction contracts, challenging market conditions, manager concerns, limited staff resources, and portfolio repositioning; staff is unable to recommend inclusion of construction contracts at this time. However, staff intends to continue to evaluate this issue. With the program extension, staff will gather and report more experience under the NTP. Also with additional time market conditions are likely to normalize. Increased experience under the existing program and improved market conditions will allow reconsideration of inclusion of construction contracts.

BACKGROUND: THE NEUTRALITY TRIAL PROGRAM

The purpose of the NTP is to gather data on the investment impact, if any, of requiring neutrality as to employee and union organizing efforts. Accordingly, the NTP applies to a limited universe of Real Estate program investments, building services contracts, and has a term of two years.

The NTP is targeted to the Core Real Estate Program investment managers. It only applies to existing managers that voluntarily agree to be bound by it and to new managers retained while the NTP is in effect. Similarly, it would apply to their existing contractors who agree to be bound by it and new contractors retained while the NTP is in effect.

Building service (e.g., janitorial, security, window washing, or food service) contracts of \$100,000 or more would be subject to the NTP. Because this would be a limited trial program, construction contracts would not be covered.

A manager and its contractors will be required to remain neutral when employees providing services pursuant to NTP-covered contracts organize, or when unions try to organize them. "To remain 'neutral' means not to take any action or make any statement that will directly or indirectly state or imply any support for or opposition to the selection by employees of a collective bargaining agent, or preference or opposition to any particular union as a bargaining agent."

If requiring neutrality would cause material adverse harm to a CalPERS investment, a manager or staff could exempt a contractor from the neutrality requirement. Normally, such exceptions could only be made after competitive bidding fails to produce an acceptable contractor who would agree to neutrality. Managers and staff would have to file reports about such exceptions and copies of those reports would be provided to unions and investment managers that request them.

Managers and contractors subject to the NTP shall file quarterly reports with staff on the impact of the neutrality requirement and related matters.

Managers participating in the NTP and their delegates will be subject to both the NTP and the Neutrality Trial RCP Policy. For all other managers subject to the RCP Policy, the August 2005 version will remain in effect.

CONCLUSION

In an effort to gather meaningful data, staff recommends that the Investment Committee approve extending the term of the NTP from March 30, 2012 to June 30, 2013. Staff will return to the Investment Committee if significant unforeseen issues arise, and to report annually on the progress of the NTP.

V. STRATEGIC PLAN:

This item supports Goal VIII to manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.

VI. RESULTS/COSTS:

There are no costs associated with this item.

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